Internal Revenue Service

memorandum

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Br1:JDMacEachen

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to: District Counsel, Cleveland CC:CLE

from: Director, Tax Litigation Division CC:TL

subject: [redacted]

This is in response to your memorandum of November 27, 1987, in which you request additional guidance with respect to the Technical Advice Memorandum of August 21, 1987, issued in the subject case.

ISSUE

Whether the [redacted] ([redacted]) is properly taxable as a pass-through entity under Subchapter J of the Internal Revenue Code. 0661-0000

CONCLUSION

The [redacted], an entity arising upon confirmation of a plan of reorganization pursuant to 11 U.S.C. §§1101-1146 is a separate taxable entity taxed as an estate pursuant to IRC §641. The income of such an estate is properly reported on Form 1041 (U.S. Fiduciary Income Tax Return). Pursuant to section 641(b), income is computed in the same manner as in the case of an individual, and the tax thereon is paid by the fiduciary. Pursuant to section 642(b), an estate is allowed a $600 deduction. However, the remainder of Subchapter J has no application to the subject entity, as it is not taxable as a pass-through entity.

We have discussed this position with the Tax Division of the Department of Justice, and, in particular, with the Appellate Section. Justice has pointed out that it makes little sense, from the standpoint of litigation, to classify the subject entity as a trust when it is clearly not taxable as such. Thus, we have requested amplification of [redacted], which concludes that the [redacted] is properly classified as a trust.

In the meantime, we have reconsidered the Conclusions reached in our August 21, 1987, memorandum, and hereby reaffirm them.

FACTS AND RATIONALE

The relevant facts are set out in our August 21, 1987, memorandum and are incorporated herein by reference.

Under the provisions of sections 1 and 63(a) of the Code, the federal income tax applies to gross income less allowable deductions. Section 641(a) specifically states that the tax imposed by section 1(e) applies to the taxable income of estates. Gross income is defined in section 61 as including all income from whatever source derived. These provisions evidence the intent of Congress to use the full measure of its taxing power. See Helvering v. Clifford, 309 U.S. 331, 334 (1940); Blassie v. Commissioner, 394 F.2d 628, 630 (8th Cir. 1968). "[T]hose who seek an exemption from tax must rest it on more than a doubt or ambiguity [since] [e]xemptions from taxation cannot rest upon mere implication." United States v. Stewart, 311 U.S. 60, 71 (1940). Moreover, express exemptions from a generally imposed tax are to be strictly construed. Helvering v. Northwest Steel Rolling Mills, Inc., 311 U.S. 46, 49 (1940); Bingler v. Johnson, 394 U.S. 741, 751-52 (1969) (See, for instance, section 7507 of the Code, providing an exemption from the income tax for insolvent and bankrupt banks). The fact that income is earned by an insolvent estate under judicial supervision does not affect its taxable status. As the Supreme Court noted in the context of property taxation, "the transfer to the trustee [gives] no mysterious or peculiar ownership or qualities ... to the property [and does not] withdraw it from the necessity of protection by the State." Swarts v. Hammer, 194 U.S. 441, 444 (1904).

In the context of an individual bankruptcy, the Service has long taken the position that the intervention of the status of bankruptcy into the affairs of the individual gives rise to a taxable entity separate and apart from the individual bankrupt, an estate in bankruptcy. See O.D. 174, 1 C.B. 175 (1919); G.C.M. 24617, 1945 C.B. 235; Rev. Rul. 68-48, 1968-1 C.B. 301; Rev. Rul. 78-134, 1978-1 C.B. 197. This has now been incorporated by statute. See section 1399 of the Code. Presumeably, this is in recognition of the economic substance of the transaction, i.e., that the individual will continue to earn post-petition income not subject to the bankruptcy, while his assets, now in the hands of the bankruptcy trustee, will also continue to earn income.

In the context of the corporate bankruptcy, the Service has agreed that the intervention of the status of bankruptcy does not give rise to a taxable entity separate from the corporation. This position, too, is in recognition of the economic substance of the transaction, i.e., a corporation is generally indistinguishable from its assets. Once a corporation has entered bankruptcy, it remains indistinguishable from its assets, having no ability to earn income in the absence of the assets. When those assets are transferred to the bankruptcy trustee and subsequently liquidated, there is no separate entity that remains independent of the assets controlled by the trustee. See Richardson v. United States, 386 F. Supp. 424, at 427 (C.D. Cal. 1974), aff'd, 552 F.2d 291 (9th Cir. 1977).

However, this analysis does not apply in the context of a corporate bankruptcy where the corporation is partially severed from its assets such that both the corporation and its assets continue to earn income independently of one another. See Krause and Kapiloff, Bankrupt Estate, Taxable Income and Trustee in Bankruptcy, 34 Fordham L. Rev. 401, 405-406 (1966). Thus, the Service has correctly taken the position that in certain instances the partial severing of a corporation from its assets has given rise to a taxable entity separate and apart from the corporate bankrupt. See [redacted], G.C.M. 39368, I-270-84, at 9 (February 21, 1985).

The bankrupt estate of an individual is taxed as an estate under section 641 and income is reported on Form 1041 (U.S. Fiduciary Income Tax Return). Pursuant to section 641(b), the income of the estate is computed in the same manner as in the case of an individual, and the tax is paid by the fiduciary. The estate is allowed a $600 deduction under section 642(b). However, the remainder of Subchapter J (sections 641-692) does not apply to an estate in bankruptcy. See Rev. Rul 78-134, supra. Thus, the bankrupt estate of an individual is not taxed as a flow-through entity like other estates.

The published Service positions, and in particular, Rev. Rul. 68-48, supra, and Rev. Rul. 78-134, supra, deal with the taxation of estates in bankruptcy under the Bankruptcy Act, originally enacted July 2, 1898. (the Act). While we agree that the subject entity is not technically a bankrupt estate, and did not arise under the Act, we do not believe that it can be distinguished for federal tax purposes from the bankrupt estates previously considered by the Service.

Section 2(17) of the Act provides that the trustee of an estate in bankruptcy is elected by the creditors and approved by the court, and may be removed by the court upon hearing after notice.

Section 70(a) of the Act provides, in part, that the trustee of the estate of a bankrupt shall be vested by operation of law with the title of the bankrupt as of the date of the filing of the petition to all property, including rights of action, which prior to the filing of the petition he could by any means have transferred or which might have been levied upon and sold under judicial process against him, or otherwise seized, impounded, or sequestered.

Section 47(a) of the Act provides the duties of the trustee as follows:

> Trustees shall (1) collect and reduce to money the property of the estates for which they are trustees, under the direction of the court, and close up the estates as expeditiously as is compatible with the best interests of the parties in interest; (2) deposit all money received... ; (3) account for and pay over to the estates under their control all interest received by them upon funds belonging to such estates; (4) disburse money only by check or draft on such depositories; (5) keep records and accounts showing all amounts and items of property received and from what sources, all amounts expended and for what purposes and all items of property disposed of; (6) set apart the bankrupts's exemptions allowed by law... ; (7) examine the bankrupt... ; (8) examine all proofs of claim and object to the allowance of such claims as may be improper; (9) oppose at the expense of estates the discharges of bankrupts when they deem it advisable to do so; (10) furnish such information concerning the estates of which they are trustees and their administration as may be requested by parties in interest; (11) pay dividends within ten days after they are declared by the referees; (12) report to the courts in writing the conditions of the estates, the amounts of money on hand, and such other details as may be required by the courts...; (13) make final reports and file final accounts with the courts... ; and (14) lay before the final meetings of the creditors detailed statements of the administration of the estates.

In 1978, the Bankruptcy Act was replaced by the Bankruptcy Code. See Bankruptcy Reform Act of 1978, Pub. L. 95-598 (1978), effective October 1, 1979. The [redacted] arose under the Bankruptcy Code, upon confirmation of a plan (the Plan) of reorganization pursuant to 11 U.S.C. §§ 1101-1146.

Upon confirmation of the Plan by the court, [redacted] transferred all of its assets with the exception of those assets necessary to manufacture and sell front axles, to the [redacted]. The Plan provides that all rights of [redacted] creditors to receive distributions are limited to the assets held by the [redacted]. [redacted], now renamed [redacted], was discharged of all pre-confirmation debt, and released from the jurisdiction of the bankruptcy court.

The trust agreement provides that, subject to the retained jurisdiction of the bankruptcy court, the trustee shall have control and authority over the trust assets to the same extent as if the trustee were the sole owner thereof. In connection with the management of the trust assets, the trustee's powers generally include the following: (1) to accept the [redacted] assets; (2) to pursue objections to claims; (3) to distribute the trust assets in accordance with the terms of the Plan; (4) to sell trust assets; (5) to prosecute or defend all actions affecting the trust; (6) to endorse the payment of notes or other obligations of any person; (7) to purchase insurance covering the liabilities of the trustee; (8) to appoint any officers, employees, etc. the trustee deems necessary; (9) to deposit monies in banks; and (10) to engage in all acts that would constitute the ordinary course of business in performing the obligations of a trustee under a trust of this type. The bankruptcy court has the authority to appoint a successor trustee in the event of the death, resignation, incompetency or removal of the trustee. Moreover, the trust must continue until it is terminated by the bankruptcy court.

The duties and powers of the [redacted] do not vary substantially from the duties and powers of trustees acting pursuant to the Act. In each case the trustee has the duty to collect, account for, and distribute the assets of the bankrupt in a manner approved by the court, and thus terminate the administration of the estate. In each case title to the assets of a bankrupt is being held by a third party, subject to the continuing jurisdiction of the bankruptcy court, for the primary purpose of satisfying, to the greatest extent possible, the claims of the bankrupt's creditors. Thus, from the standpoint of the federal income tax, the two entities, each separate and distinct from the party whose assets they contain, are indistinguishable, and must be treated similarly.

Having concluded that the subject entity is indistinguishable for federal tax purposes from the bankrupt estate of an individual, we now address the reasons flow-through taxation is indefensible in the context of a bankruptcy proceeding.

First, the portion of Subchapter J held to be inapplicable to the bankrupt estate of an individual is that portion which contemplates the taxation of decedent's estates and private trusts as flow-through entities. Income received by a decedent's estate is taxed to the estate unless that income is distributed to the beneficiaries. Income distributed to the beneficiaries by the estate is taxed to the beneficiaries. Section 643(c) defines the term beneficiary to include heirs, legatees, and devisees. A creditor is not a beneficiary within the meaning of the statute. <u>See</u> Rev. Rul. 68-48, <u>supra</u>; <u>Trust Estate of Thomas Lonegan v. Commissioner</u>, 6 T.C. 715, 719 (1946).

Furthermore, distributions payable to creditors as bankruptcy dividends lose their character as estate income, and are not in the nature of income when recieved by the creditors. See G.C.M. 24617, 1945-1 C.B. 235. Thus, while in form a bankrupt estate is similar to a decedent's estate, it is the fundamental difference between a creditor and a beneficiary which has resulted in the substantial differences in the tax treatment of each. Creditors, who do not take by gift, bequest, devise, or inheritance (compare section 102(a) of the Code), nor from one who did so take, were simply not contemplated as being part of a flow-through scheme of taxation.

Secondly, the application of the flow-through principle of Subchapter J to a separate taxable entity arising in the context of a bankruptcy proceeding results in double taxation of the same amounts to the creditors.

For example, assume that the trustee recieves $100 of interest income, and has $25 of deductible expenses. The $75 remaining after payment of expenses is distributed to creditor A in full satisfaction of his claim of $1000 for goods previously furnished the bankrupt. Pursuant to section 643 the trust has distributable net income of $75. The trust would receive a $75 deduction pursuant to section 661(a) for amounts distributed to A, resulting in $0 taxable income to the trust.

However, pursuant to section 662(a), the $75 distribution would be includible in the income of A. Pursuant to section 662(b), the $75 would have the same character in the hands of A as it did in the hands of the trust. Such treatment is anomalous in that A already has a tax basis in the $75 of $1000, and is merely receiving a partial return of his capital.

Further, the $75 would be determinative of A's own bad debt deduction. Having received $75, A's bad debt deduction is limited to $925 ($1000 minus $75). Assume that A is in the 50% bracket, and that Subchapter J is consistently applied. A would pay $37.50 of tax on the $75 bankruptcy dividend. Thus, the net proceeds received by A would actually be $37.50 ($75 received minus $37.50 of tax). Despite the fact that A now has an economic loss of $962.50 in connection with his claim against the bankrupt, his bad debt deduction would be limited to $925. Not only would A be taxed on the $75, an amount in which he already had a full tax basis, but A would also lose the benefit of a bad debt deduction in the full amount of his economic loss. In effect, A would be taxed twice on the same amount.

Having concluded that the [redacted] is not taxable as a flow-through entity under Subchapter J, we now turn to the application of section 641.

Section 6012(a)(3) of the Code provides that every estate, the gross income of which is $600 or more for the taxable year shall make a return with respect to income taxes. Section 6012(b)(4) states that returns of an estate, a trust, or an estate of an individual under chapter 7 or 11 of title 11 of the United States Code shall be made by the fiduciary thereof.

Treas. Reg. § 1.6012-3(a)(1)(i) provides that every fiduciary must make a return of income on Form 1041 for each estate for which he acts if such estate has gross income of $600 or more for the taxable year.

Section 6151(a) provides, in pertinent part, that when a return of tax is required under this title, the person required to make such return shall, without assessment or notice and demand pay such tax at the time and place fixed for filing such return (determined without regard to any extension of time for filing the return).

Section 7701(a)(6) defines the term "fiduciary" as a guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person.

Treas. Reg. § 1.641(a)-2 provides that the gross income of an estate is determined in the same manner as that of an individual. Thus, gross income of an estate consists of all items of gross income received during the taxable year.

Treas. Reg. § 1.641(b)-1 provides that generally, the deductions and credits allowed to individuals are allowed to the estate. The allowance of deductions "depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed." New Colonial Ice Co., Inc. v. Helvering, 292 U.S. 435, 440 (1934).

Generally, where the trustee does not operate a trade or business, expenses of the estate are deducted under section 212, relating to the deduction of ordinary and necessary expenses paid or incurred for the production or collection of income. See Rev. Rul. 68-48, supra.

Treas. Reg. § 1.212-1(a) provides that an expense may be deducted under section 212 only if-

(1) It has been paid or incurred by the taxpayer during the taxable year (i) for the production or collection of income which, if and when realized, will be required to be included in income for Federal income tax purposes, or (ii) for the management, conservation, or maintenance of property held for the production of such income, or (iii) in connection with the determination, collection, or refund of any tax; and

(2) It is an ordinary and necessary expense for any of the purposes stated in subparagraph (1) of this paragraph.

Treas. Reg. § 1.212-1(b) provides that the term "income" for the purpose of section 212 includes not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years; and is not confined to recurring income but applies as well to gains from the disposition of property. For example, if defaulted bonds, the interest from which if received would be includible in income, are purchased with the expectation of realizing capital gain on their resale, even though no current yield thereon is anticipated, ordinary and necessary expenses thereafter paid or incurred in connection with such bonds are deductible. Similarly, ordinary and necessary expenses paid or incurred in the management, conservation, or maintenance of a building devoted to rental purposes are deductible notwithstanding that there is actually no income therefrom in the taxable year, and regardless of the manner in which or the purpose for which the property in question was acquired. Expenses paid or incurred in managing, conserving, or maintaining property held for investment may be deductible under section 212 even though the property is not currently productive and there is no likelihood that the property will be sold at a profit or will otherwise be productive of income and even though the property is held merely to minimize a loss with respect thereto.

Treas. Reg. § 1.212-1(d) provides that expenses, to be deductible under section 212, must be "ordinary and necessary". Thus, such expenses must be reasonable in amount and must bear a reasonable and proximate relation to the production or collection of taxable income or to the management, conservation, or maintenance of property held for the production of income.

Treas Reg. § 1.212-1(i) provides, in part, that reasonable amounts paid or incurred by the fiduciary of an estate or trust on account of administration expenses, including fiduciaries' fees and expenses of litigation, which are ordinary and necessary in connection with the performance of the duties of administration are deductible under section 212 notwithstanding that the estate or trust is not engaged in a trade or business, except to the extent that such expenses are allocable to the production or collection of tax-exempt income.

The transfer of a bankrupt's assets to a trustee in bankruptcy is not a taxable event. The estate in bankruptcy succeeds to the bankrupt's basis and holding period, and the character of the transferred assets remains the same in the hands of the trustee for purposes of determining whether a sale creates ordinary versus capital gain or loss. See Rev. Rul. 78-134, supra; [redacted], G.C.M. 37061, I-530-76 (March 25, 1977); Rev. Rul. 68-48, supra. Gain or loss on disposition will be recognized accordingly. One who transfers property to his creditor in satisfaction of an obligation recognizes gain or loss on the difference between the fair market value of the property and its basis, just as if he had sold the property and used the proceeds to satisfy the debt. See United States v. Davis, 370 U.S. 65 (1962); United States v. General Shoe Corp., 282 F.2d 9, 12 (6th Cir. 1960), cert. denied, 365 U.S. 843 (1961); Lutz and Schramm Co., 1 T.C. 682, 688-89 (1943); Carlisle Packing Co., 29 B.T.A. 514 (1933).

Accordingly, the [redacted] is not taxable as a pass-through entity. The trustee must determine his tax liability in the same manner as an individual. Like all trustees, he is allowed the deductions and credits allowable to individuals. However, "only as there is clear provision therefor can any particular deduction be allowed." New Colonial Ice Co., Inc. v. Helvering, supra, at 440. The basis, character and holding period of the [redacted] assets, for purposes of computing gain or loss, will be a carryover of the basis, character and holding period of those assets in the hands of [redacted] on the date the [redacted] was funded.

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